Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SEA:POR:POSTF-124321-02
JMDewey

date: August 6, 2002

to: LMSB Group [redacted]
Attn: [redacted], Revenue Agent

from: Associate Area Counsel
(CC:LM:CTM:SEA:POR)

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subject: **Capitalization of "Past Service" Pension Costs**

Taxpayer: [redacted] and Subsidiaries
Tax years: [redacted] - [redacted]

This memorandum responds to your request for assistance on the question of whether certain payments alleged to have been made for past-service pension costs must be capitalized to current assets or, in order to determine whether I.R.C. § 263A would apply, should be traced back to the asset construction periods when the pension payment obligations arose. It is our opinion, as discussed below, that the pension costs at issue should be capitalized to current assets.

FACTUAL BACKGROUND

The above-named taxpayer ([redacted] is a consolidated group of corporations which provides [redacted] services and conducts related business activities in the [redacted]. In [redacted] [redacted] merged with [redacted], another [redacted] company. At that time, asserts the taxpayer, [redacted]'s pension plan was fully funded but [redacted]'s plan was under-funded by approximately $[redacted]. Subsequently, due to early retirement programs offered following the merger, the under-funding of petitioner's pension plan became even greater.

During the [redacted], the Pension Benefit Guaranty Corporation repeatedly identified [redacted]'s pension plan as one of the [redacted] underfunded pension plans. [redacted].

Prior to taxable year [redacted], [redacted] accrued the pension costs attributable to its [redacted] in an account entitled "[redacted]." The balances in this and other employee benefit accounts were then transferred to a payroll clearing account. The purpose of this transfer was to facilitate the allocation of employee benefit costs between "operation & maintenance" (O&M) expense and capital (construction project) costs. For four of the years under examination ([redacted] through [redacted]), the allocation of employee benefits was made on the same percentage basis as that applied to employee wages. For these years, the pension costs for [redacted] posted to [redacted] and the percentage of these costs which were capitalized to "self constructed assets," were as follows:

[redacted]	$[redacted]	[redacted]%
		%
		%
		%

For [redacted], the final year under examination, the percentage of employee wages that were so capitalized was [redacted]%. However, this percentage was not applied to the "pension" portion of employee benefit costs. Unlike prior years, [redacted] did not accrue the majority of its qualified pension plan costs in [redacted]. Of the total accrued ($[redacted]), $[redacted] was charged to "[redacted]" but $[redacted] was charged to "[redacted]." Only the amount in [redacted] was transferred to a payroll clearing account and allocated between capital ([redacted]%) and O&M ([redacted]%) costs. The amount in [redacted] was expensed, and deducted in full for tax purposes.

Upon enquiry, the taxpayer provided an explanation as follows: During [redacted] through [redacted], [redacted] funded more than $[redacted] in pension costs. Some of these costs were "catch up" payments designed to achieve full-funding for all its pension plans. The under-funding resulting from early retirement programs was reversed by payments made prior to [redacted]. Of the amount funded in [redacted], $[redacted] was paid to fully fund the pension liabilities assumed by [redacted] upon its merger with [redacted]. With this [redacted] funding, the qualified pension plan administered by the taxpayer became fully funded.

[redacted] asserts that the "catch-up" contributions made to cure the under-funding caused by early retirement programs were properly allocated to O&M expense and capital costs in the years the contributions were made. However, the [redacted] contributions were made to restore adequate funding for pension liabilities which arose during [redacted]'s operation, which largely took place before the Unicap rules were enacted. The $[redacted] at issue is described by the taxpayer as a "large one-time" "early retirement accrual" "not related to any capital project" and not allocated between O&M expense and capital projects because "it would have inaccurately overstated" capital costs. Thus, asserts the taxpayer, pension costs arising from [redacted]'s operations should be fully expensed because section 263A does not apply to them.

However, although requested to do so, [redacted] has not provided any records or information which show that the pension costs entered into [redacted] in [redacted] were in any substantive way different from those costs entered into [redacted] either in [redacted] or in the prior years under examination. In particular, the taxpayer has not shown that the "catch-up" portion of its [redacted] pension plan accruals were in any way different from earlier years' accruals, or that they were treated differently by pension plan administrators. It has not even been shown that the [redacted] "catch-up" contribution was made in the form of a single, "one-time" payment, as alleged by the taxpayer.

The treatment afforded the amount accrued in [redacted] in [redacted] is different from the method used to account for analogous costs in prior years. It is also contrary to the accounting policy set forth in a [redacted] company memorandum which states that "[redacted].

You have determined that the $[redacted] in pension costs accrued in [redacted] in [redacted] were indirect costs subject to the provisions of section 263A, and that this would be true even if the taxpayer could demonstrate that most or all of the costs were incurred based on services rendered in earlier years, in particular, in the years prior to December 31, 1986. At issue is an adjustment for the [redacted] tax year in the amount of $[redacted]. You have requested our legal analysis and opinion on this matter.

ANALYSIS AND DISCUSSION

The Unicap rules, established by section 263A and related regulations, provide that the direct and indirect costs of inventory and of self-constructed assets must be capitalized to the basis of these assets. The indirect costs properly allocated to property acquired for resale or produced include pension and related costs. Treas. Reg. § 1.263A-1(e)(3)(ii)(C).

When section 263A was first enacted, there was an exception to this rule for certain plan contributions related to "past services." This was reflected in Temp. Treas. Reg. § 1.263A-1T(b)(2)(v)(H)(1), which provided that among the indirect costs not required to be capitalized were contributions paid to or under a pension or annuity plan allowable as a deduction under I.R.C. § 404 to the extent such contributions represent past service costs as determined under the particular funding method established for the plan under the provisions of I.R.C. § 412. However, Section 10204 of the Omnibus Budget Reconciliation Act of 1987, P.L. No. 100-203, eliminated this exception. The change was effective beginning after December 31, 1987. The permanent regulations under section 263A, applicable after December 31, 1993, take this into account. Treas. Reg. § 1.263A-1(e)(3)(ii)(C) provides that indirect costs include "contributions paid to or made under any stock bonus, pension, profit-sharing or annuity plan, or other plan deferring the receipt of compensation..." and that "[c]ontributions to employee plans representing past services must be capitalized in the same manner (and in the same proportion to property currently being acquired or produced) as amounts contributed for current service."

According to information provided by the taxpayer, the costs at issue here represent contributions made to a qualified plan, which would be deductible under I.R.C. § 401; accordingly, even if the originally-enacted exception for certain "past service" costs were still in effect, the costs at issue would not be excepted from the capitalization requirement for indirect costs. In any event, that exception does not apply to contributions made after December 1987. Although most of the liability for the costs at issue here may have arisen from services performed before [redacted], the costs were actually accrued in [redacted], since this is when economic performance occurred. See I.R.C. § 461(h)(1) and Treas. Reg. § 1.461-1(a)(2). Therefore, these costs must be capitalized under the Unicap rules in the same way that current service costs are capitalized.

The taxpayer's primary argument, however, is that the Unicap rules do not apply because the "one-time" payment of $[redacted] made in [redacted] was for past-service pension costs relating "nearly 100 percent" to work associated with the production of property acquired in the [redacted] merger. "Virtually all" of this property was already in service on or before December 31, 1986, the date the Unicap rules became effective. Thus, such property was exempt from the Unicap rules. (No substantiation has been provided for these factual allegations other than to emphasize the [redacted] date of the merger.) The taxpayer cites Treas. Reg. § 1.263A-1(e)(1) which provides that indirect costs are allocable to "property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities." [redacted]s argument seems to be that, because (most of) the services performed by employees which gave rise to pension obligations under [redacted]'s plan were performed prior to 1986, these obligations comprised part of the cost of self-constructed assets produced prior to 1986. Thus, these costs "benefitted or were incurred by reason of" these employee services and, since the Unicap rules did not apply to such property or such services, the pension plan obligations relating to these services, including the [redacted] "catch-up" contribution, should also not be subject to the Unicap rules.

The taxpayer further argues that the changes made by the Omnibus Budget Reconciliation Act of 1987 did not alter this analysis. The changes made by this Act were effective for costs incurred after December 31, 1987, in taxable years ending after such date. (See the Conference Report accompanying the 1987 Act, H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess., 1987-3 C.B. 204.) The taxpayer asserts that the "catch-up" pension contributions made in [redacted] were actually incurred prior to December 31, 1987, thus this change in the law simply does not apply to these indirect costs.

The taxpayer's arguments are vague and somewhat convoluted as compared to regulation § 1.263A-1(e)(ii)(C) cited above, the wording of which is clear and straight-forward: contributions currently made to employee plans, even if they arise from past services, must be allocated, and an appropriate proportion must be capitalized to currently-produced property. We think this language applies to contributions arising from all past services, including those performed prior to either December 31, 1987 or December 31, 1986.

Finally, an additional argument may be made to support your adjustment. Because the taxpayer has not demonstrated that the "catch-up" pension contributions entered into [redacted] and fully expensed in [redacted] were in any substantive way different from "catch-up" contributions made in prior tax years, a portion of which were capitalized to current assets, the [redacted] change in the way these pension plan costs were accounted for represents an unauthorized change in a method of accounting under the provisions of I.R.C. § 446(e) and Treas. Reg. § 1.446-1(e)(3)(i). Thus, a portion of the deduction claimed may be disallowed on this basis.

If you have any questions or comments about this memorandum, please call the undersigned at (503) 326-3100, extension 248.

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